Robotti
Value Investors

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Dear Client,

This has been a challenging year for value investors such as ourselves. It's not surprising when the vast majority of stock trading is driven by capital flowing into passive investment strategies, buy or sell transactions generated by pure quantitative models or some derivative of the two. This kind of formulaic investing pushes money to previous winners – "don't fight the trend" is one of those market axioms for stock traders. Recent outperformance is rewarded with an inflow of even more capital, and companies heavily weighted in the index have done well because of it, leading to a bifurcation between the "winners" and the laggards. Additionally, it appears that investors have taken to kicking the laggards while they are down, or more specifically because they are down. As a result, much of our capital is invested in companies that have earnings multiples under 10x – an extremely modest valuation today when the 10 year treasury notes currently yield 3.2%, and inverting that implies a 31x earnings multiple. We remind you of Ben Graham's belief that in the short-term markets are a "voting machine" based on popularity but eventually they become a "weighing machine," weighing intrinsic value, or the present value of cash flows each business generates. Our portfolio is populated with businesses that are heavyweights when measured on the valuations.

As you know, our portfolio is currently heavily invested in two industries: energy services and homebuilding related businesses. These are both industries where we believe we have developed core competencies and a deep understanding of the industry dynamics. Both industries are in extremely different phases of their cyclical lives, but the one trait they have in common is that security prices in both industries have deviated from business fundamentals.

Energy

In the oil and gas business the headline grabbing leading indicator is the price of oil. If you filled up your car recently you've noticed oil prices have more than doubled in the last few years. The price of oil recently hit its highest level in four years, and even though the industry has consolidated, costs have come down, and the supply/demand equation is more strongly in their favor, oil and gas services companies have yet to rebound.[1] More important than the price of the commodity, is the price point at which it can be economically extracted. To that end, we've seen dramatic cost reductions for producers, which has and should continue to, lead to increased activity. That rebound is held back by inevitable "capital discipline" which permeates cyclical businesses at weak periods. The economic equation changes, but the dismal experience of investing at a market top (2013-2014) prevents capital spending, further compounding the opportunity today.

Despite this fundamental improvement, security markets have taken the sanguine view that these improvements don't matter. The chart below highlights this dramatic disparity. Yet as day follows night we're convinced the earnings turn around and ramp up is within sight.

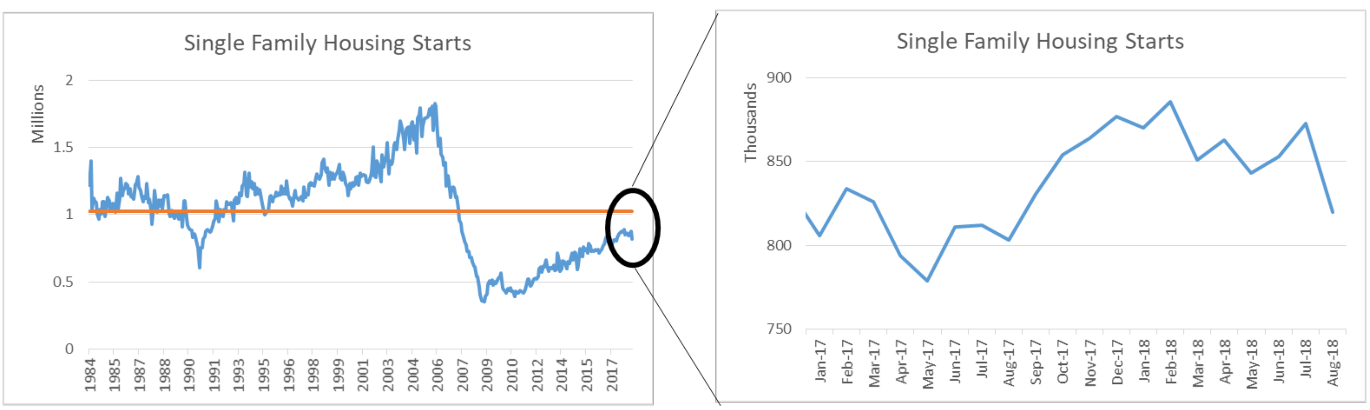
Housing

Among our holdings in the housing industry, we have one of our largest contributors to performance, one of our largest detractors from performance, and one that has remained in a holding pattern. The drivers for each of these scenarios are unique, but many of the overarching themes are similar. In building suppliers and distributors, we have seen the entire sector contract, specifically our investment in Builders FirstSource (Nasdaq:BLDR). We have also seen a long dormant manufactured housing industry begin to awaken in a meaningful way, which has given us one of our top performers, Cavco (NYSE:CVCO). Finally we have seen our investment in Norbord (NYSE:OSB) dip slightly as the market focuses on the short-term pricing dynamics of their goods.

In 2018 we have generally seen significant share price contraction across the homebuilding sector. As one of our largest holdings, the share price decline of BLDR weighed heavily on our performance. We have talked about BLDR

[1] Capital IQ data

on numerous occasions, but it is times like this that it is important that we review and relate to you our investment thesis. As you can see from the chart below, the number of single-family housing starts has been rising steadily since the housing crisis, but this year the recovery is taking a breather. This often happens, as recoveries rarely, if ever, follow a straight path up and are more likely to take two steps forward and one step back. In our experience it is common for investors to prematurely decide that every time there is a step back, the recovery is over. For all the panic the market has had over a slowdown in single family housing starts (as evidenced by share price reductions) none of that has flowed through to the financials of BLDR as of yet. If anything we've seen the opposite, as results have continued to improve. Recently, a well-respected market analyst Ivy Zelman described this phenomenon very succinctly saying, "This is a taper tantrum." As the growth of single-family housing starts has tapered, investors are throwing a tantrum. This is where we would highlight short-term versus long-term thinking. The short-term investor is looking at the chart on the right, while we are looking at the chart on the left. The fact remains for the last 12 years we have built fewer homes per year than at any point in the last 35 years, all while our population has grown. What we see today in BLDR is a better company with a better balance sheet and better competitive position than it was last year with an even a more modest valuation.



Now compare and contrast that to our investment in another part of the housing industry - manufactured housing. One of our largest holdings is Cavco Industries (NYSE:CVCO) which has done phenomenally well this year. What we are seeing in manufactured housing is the manifestation of a very long-term process. The pullback in MH (manufactured housing) happened before the general housing crisis, and as such the industry has had more time to consolidate and streamline than the broader housing sector. Today the top three MH producers are 78% of the market, after a merging of the #2 and #4 players in the industry. Cavco itself is the result of a merger between 3 top-10 companies in the industry approximately 10 years ago; the legacy Cavco, Fleetwood and Palm Harbor. See our note below on consolidating cyclical businesses.

What's more amazing is that this has been done despite the fact that financing for this industry is even more restrictive than it is for site-built housing. Historically, similar to site-built homes, access to financing is a very important aspect of the industry. After the financial crisis, regulations were put in place that made it much harder to borrow money to buy a home, and the MH industry was the poster child for reform due to its natural constituency being more financially unsophisticated. Despite this extremely constrained financing environment the manufactured housing industry has rebounded dramatically given its low cost advantage in the financially constrained world. However that soon may be changing. In recent months Fannie Mae and Freddie Mac have both announced plans to help the MH industry, as they have come to the realization that it is an integral part of the affordable housing crisis solution. This should turbocharge an already robust recovery. With regulatory relaxation and robust demand, the entire industry is poised to continue to perform very well. But as we have already mentioned, recoveries are not linear, and it is important to be prepared for that.

Norbord's shares have experienced a large amount of volatility throughout the year. The price of oriented strand board (osb), a key driver of this business, has whipsawed back and forth. Even with the volatility of their end product's price, the supply-demand dynamic is still very much in Norbord's favor. This is a company emerging from a down-cycle in a dominant position, with a management team that has proven to be excellent capital allocators. So far this year, the company has paid a special dividend of C$4.50, had little change in capacity forecasts, and yet the stock remains slightly down for the year closing at approximately C$40 per share as of October 1st. The dividend distribution amounted to approximately $300 million US and was in excess of all capital needs. Further, we believe they should continue to generate similar excess free cash flow in the second half of the year. Longer term, North American industry utilization is near 90% and with limited ability for the industry to add capacity without building new mills, a process that will take at least several years, Norbord remains in an excellent position to experience several years of robust free cash flow generation. Management has a history of returning that cash to shareholders, both in the form of dividends and buybacks, and we believe they will continue to do so going forward.

Consolidation

Investing in cyclical industries is a key part of our investment toolkit. Of course we would be remiss to not point out the recurring theme of many of our companies - consolidation. The kind of consolidation that typically occurs during an industry downturn is often a key factor and its benefits can take many forms. The osb industry has dramatically consolidated through the downturn in housing over the last decade or so. Today, 5 companies control close to 80% of the industry capacity and all of the available incremental capacity. Norbord itself is the result of a merger with another large industry participant, Ainsworth. Today Norbord is reaping many of the rewards of that consolidation and appears extremely well-positioned. We already touched on the consolidation in the manufactured housing industry, and have previously discussed the BMC/STCK merger. Across homebuilding we have seen huge amounts of consolidation leading to an industry that we believe is poised to reap huge rewards from the continued housing recovery.

While the consolidation in housing has been going on for the last decade, in energy we have seen this process unfold over the last four or five years. We have benefited directly, as in the case of the Tidewater (NYSE:TDW) / GulfMark (NYSE:GLF) merger and Atwood / Ensco (NYSE:ESV) deal. We reiterate that this is also a benefit for the industry as a whole. It removes bad competitors, reduces costs and improves synergies. This confluence of events often leaves the surviving companies ready to produce large amounts of cash as the rebound takes hold.

While homebuilding and energy are obviously large holdings, we see this trend in other investments we have. Companies such as Radnet (NYSE:RDNT) and Westlake (NYSE:WLK), have also seen meaningful consolidation. Radnet has been consolidating medical centers for years, while Westlake merged with a main competitor Axiall. We talked about Radnet and Westlake in our Q3 2017 letter and in an investment presentation respectively (we are happy to make either of these available to any interested clients). These types of consolidations strengthen the companies' competitive positions (provided they are priced correctly). Our assessment of management's capital allocation skills in each of these transactions is key to our evaluation of our investments.

Conclusion

We want to thank you again for your commitment. Clients like yourselves make our style of investing possible. We look forward to continuing to work towards providing you with quality returns.

All the Best,

Bob Robotti

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